Part III - Administrative, Procedural, and Miscellaneous

Certain Distributions Treated As Sales or Exchanges

Notice 2006-14

Section 1. PURPOSE

This notice invites public comments on certain distributions treated as sales or exchanges under § 751(b) of the Internal Revenue Code.

Section 2. BACKGROUND

Section 751 was enacted to prevent the conversion of ordinary income into capital gain and the shifting of ordinary income among partners. See H.R. Rep. No. 1337, at 70 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4097. Section 751(a) provides for recharacterization of capital gain or loss when an interest in a partnership is sold or exchanged to the extent of the selling partner's share of unrealized receivables and inventory items of the partnership. Section 751(b) overrides the nonrecognition scheme of § 731 for certain current and liquidating partnership distributions that alter a partner's share of unrealized receivables and substantially appreciated inventory items (disproportionate distributions). Section 751(b)(1) provides:

(1) GENERAL RULE.—To the extent a partner receives in a distribution—

(A) partnership property which is— (i) unrealized receivables, or (ii) inventory items which have appreciated substantially in value, in

> exchange for all or a part of his interest in other partnership property (including money), or
>
> (B) partnership property (including money) other than property described in subparagraph (A)(i) or (ii) in exchange for all or part of his interest in partnership property described in subparagraph (A)(i) or (ii), such transactions shall, under regulations prescribed by the Secretary, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

The legislative history of § 751 demonstrates that Congress was primarily concerned with unrealized appreciation in unrealized receivables and inventory items of a partnership.

> The provisions relating to unrealized receivables and appreciated inventory items are necessary to prevent the use of the partnership as a device for obtaining capital-gain treatment on fees or other rights to income and on appreciated inventory. Amounts attributable to such rights would be treated as ordinary income if realized in normal course by the partnership. The sale of a partnership interest or distributions to partners should not be permitted to change the character of this income. *The statutory treatment proposed, in general, regards the income rights as severable from the partnership interest and as subject to the same tax consequences which would be accorded an individual entrepreneur*.

S. Rep. No. 1622, at 99 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4732 (emphasis added).

The current regulations under § 751(b) require the identification of two classes of assets: (1) hot assets (unrealized receivables as defined in § 751(c) and substantially appreciated inventory as defined in § 751(b)(3) and (d)); and (2) cold assets (assets other than unrealized receivables and substantially appreciated inventory). In computing the distributee partner's income under § 751(b), the current regulations provide that the distributee partner's share of the partnership's hot assets and cold assets before and after the distribution must be compared. For purposes of this comparison, each partner's share of the partnership's hot and cold assets is determined by reference to the gross value of the assets. If the distribution results in an exchange of all or a portion of the distributee partner's share of one class of assets (relinquished assets) for assets in the other class (acquired assets), it is necessary to construct a deemed exchange by identifying which relinquished assets are treated as exchanged for which acquired assets.

For example, if a partner receives more than the partner’s share of the partnership’s hot assets in a distribution, that partner is treated as exchanging a portion of the partner’s interest in certain cold assets of the partnership for the other partners’ shares of the acquired hot assets. In order to accomplish the exchange, the distributee partner is treated as (1) receiving the relinquished assets (the cold assets) in a nonliquidating distribution and (2) engaging in a taxable exchange (with the partnership) of those assets for the acquired assets (the hot assets). Both the distributee partner and the other partners may recognize income or loss on the exchange. The distributee partner and the partnership then hold the exchanged assets (or portions thereof) with a cost basis under § 1012. The rest of the actual distribution (the part that is not subject to § 751(b)) is characterized under the general rules for partnership distributions prescribed in §§ 731 through 736.

The current regulations under § 751(b) were published in 1956 and have not been amended to reflect significant changes in subchapter K and in the operations of contemporary partnerships. Moreover, the current § 751(b) regulations have been widely criticized as being extraordinarily complex and burdensome and as not achieving the objectives of the statute. As a result, a distribution may reduce a partner’s pro rata share of the unrealized appreciation in the partnership’s hot assets without triggering

§ 751(b), and a distribution can trigger § 751(b) even if the partner's pro rata share of the unrealized appreciation is not reduced.

The Treasury Department and the Service are considering several possible methods, discussed below, for addressing the issues associated with the current § 751(b) regulations.

Section 3. DISCUSSION

(a) Determining the partners' shares of partnership property

The current regulations under § 751(b) provide little guidance on how each partner's share of partnership property is determined. Two economic rights are inherent in most partnership interests: a right to partnership capital, and a right to partnership profits and losses. A partner may have a different interest in each of these rights, and those interests may vary over time. Moreover, a partner's share of unrealized partnership items may be affected by both the economic arrangement of the partners and certain requirements of subchapter K, such as § 704(c).

The legislative history of § 751(b) emphasizes "income rights" of the partners and suggests that these rights may be treated as severable and subject to the same tax consequences as those of an individual entrepreneur. S. Rep. No. 1622, at 99. Consistent with this legislative history, in order to determine whether a distribution may be subject to § 751(b), commentators have suggested that new regulations could require partnerships and their partners to compare the amounts of ordinary income that would be recognized by the partners if the partnership's hot assets (including distributed assets) were sold or exchanged for fair market value in a taxable transaction both before and after the distribution (hypothetical sale approach). If the amount of ordinary income that would be allocated to any partner (including the distributee) as a result of such a sale or exchange is reduced as a result of a distribution from the partnership, an analysis under § 751(b) would be required. The hypothetical sale approach, combined with the application of § 704(c) principles, could provide rules that achieve the objective of the statute in a less burdensome manner.

Under § 704(c), if partnership property is sold or exchanged, the built-in gain or loss in contributed or revalued partnership property must be allocated to the contributing or appropriate historic partner (§ 704(c) principles). See § 704(c)(1)(A) and §§ 1.704-1(b)(4)(i), 1.704-3(a)(2), and 1.704-3(a)(6). As a result of the application of § 704(c) principles, there can be layers of appreciation in partnership assets (due to successive revaluations), each of which may be allocable separately. Moreover, distributed § 704(c) property and § 704(c) property with a substantial built-in loss must be analyzed separately to determine each partner's appropriate share of the unrealized gain or loss. See, e.g., § 704(c)(1)(B) and (C). As a result, § 704(c) generally operates to preserve each partner's share of the built-in appreciation and depreciation in partnership assets. If the regulations under § 751(b) were amended to specify that § 704(c) principles are taken into account for purposes of determining whether a partner's share of partnership hot assets has been altered by a distribution, significantly fewer distributions would trigger § 751(b).

Example 1. Assume that A, B, and C each contribute $120 to partnership ABC. ABC purchases land for $210, which appreciates in value to $300. At a time when the partnership also has $90 of zero-basis unrealized receivables and cash of $150, ABC distributes $90 to C, reducing C's interest in ABC from 1/3 to 1/5. If, immediately before the distribution, the partnership's assets are revalued and the partners' capital accounts are increased to reflect each partner's share of the unrealized appreciation in the partnership's assets, C's entire pre-distribution share of the partnership's unrealized income in the accounts receivable (1/3 of $90, or $30) is preserved in C's capital account after the distribution. ABC will have the following post-distribution balance sheet (before the application of section 751(b)):

Assets	Basis	Value	Capital	Basis	Value
Cash	$60	$60	A	$120	$180
Unrealized Receivables	$0	$90	B	$120	$180
Land	$210	$300	C	$ 30	$ 90
Total	$270	$450		$270	$450

If § 704(c) principles were applicable for purposes of § 751(b), the distribution to C would not trigger § 751(b), as C's pre-distribution share of the unrealized income in the receivables ($30) is fully preserved in its capital account after the distribution. Section 704(c) principles would require the partnership to allocate that share of appreciation to C when it is recognized.

Special rules may be necessary to address distributions of hot assets to a partner where the adjusted basis of the distributed assets (and the unrealized appreciation in those assets) is different in the hands of the distributee partner than it was in the hands of the partnership. Under §§ 732(a)(2) and (b), the adjusted basis of distributed hot assets is reduced (and the unrealized appreciation in those hot assets is increased) if the distributee partner's basis in its partnership interest is insufficient to absorb the partnership's adjusted basis in the distributed hot asset. If the partnership has a § 754 election in effect at the time of the distribution, § 734(b)(1)(B) permits the partnership to increase the adjusted basis of the partnership's retained hot assets to the extent of the reduction in the basis of the distributed hot assets under § 732(a)(2) or (b). Under these circumstances, the hot asset appreciation remaining in the partnership is reduced. As such, one of the issues raised by use of a hypothetical sale to measure changes in a partner's interest in hot asset appreciation is the extent to which basis adjustments under §§ 732 and 734(b) should be taken into account.

Moreover, a hypothetical sale at any one point in time does not take into account future allocations that are planned or expected. For example, a partner's allocations with respect to a particular asset may vary over time. Measuring income or loss on a hypothetical sale of that asset at a particular time may not accurately reflect that partner's income rights with respect to that asset over the life of the partnership.

Once it is determined that a partner's share of the income rights in the partnership's hot assets has been reduced by a distribution, the tax consequences of the distribution under § 751(b) must be determined.

(b) Determining the tax consequences of disproportionate distributions

The current § 751(b) regulations impose a complex deemed distribution/ exchange approach for determining the tax consequences of a disproportionate distribution. One possible way to simplify this determination would be to treat a disproportionate distribution as triggering a taxable sale of the partners' shares of relinquished hot assets to the partnership immediately before the distribution (hot asset sale approach). The hot asset sale approach would apply § 751(b) in a fully aggregate manner that is arguably consistent with its legislative history (under which each partner's tax treatment should be that of an individual entrepreneur).

This approach could be combined with the hypothetical sale approach. Thus, new regulations could provide that § 751(b) applies if any partner's share of the net unrealized appreciation in hot assets of the partnership is reduced as a result of a distribution from the partnership. Under the hot asset sale approach, for any partner whose share of hot assets is reduced (selling partner), whether or not the selling partner is the distributee, the selling partner would be treated as receiving the relinquished hot assets in a deemed distribution and selling to the partnership the relinquished share of the hot assets immediately before the actual distribution. The selling partner would recognize ordinary income from the deemed sale, and the partner's basis in the partnership interest and the partner's capital account would be adjusted to reflect the consideration treated as contributed to the partnership. The assets deemed sold to the partnership would have a cost basis under § 1012. Under the hot asset sale approach there would be no deemed exchange for cold assets, thereby eliminating the need to identify cold assets to be exchanged and to construct a deemed distribution of those assets.

The hot asset sale approach can be straightforward if the distributee partner's share of hot asset appreciation is reduced by the distribution. In this situation, the partnership would be treated as distributing the relinquished share of hot assets to the distributee who sells the hot assets back to the partnership, recognizing ordinary income, with appropriate adjustments to the distributee partner's basis in the partnership interest and capital account. The asset deemed sold would take a cost basis, and the distribution would be governed by §§ 731 through 736.

<u>Example 2</u>. Assume <u>A</u>, <u>B</u> and <u>C</u> are each 1/3 partners in a partnership that holds one hot asset and one cold asset, each with a basis of $0 and a fair market value of $150. <u>A</u>, <u>B</u>, and <u>C</u> each have an adjusted basis in the partnership interest of $0, and a $50 share of hot asset appreciation. <u>A</u> is fully redeemed by a distribution of 2/3 of the cold asset ($100). Immediately before the distribution, the partnership's assets are revalued and the partners' capital accounts are increased to $100 to reflect each partner's share of the unrealized appreciation in the partnership's assets. Because the entire $150 of hot asset appreciation remains in the partnership after the distribution, <u>A</u>'s share of that appreciation has been reduced by $50. Under the hot asset sale approach, <u>PRS</u> would be treated as distributing the relinquished share of the hot asset

($50) to A and then purchasing that share for $50. A would recognize income of $50 and would be treated as contributing the $50 to PRS. A's basis in the partnership interest would increase to $50 and A's capital account would be restored to $100. The portion of the hot asset deemed sold would take a cost basis, increasing the partnership's basis in the hot asset to $50.

In this example, because A's basis in its partnership interest is $50, the basis of the distributed cold asset would be increased under § 732(b) to $50 in A's hands. The cold asset remaining in the partnership has a $0 basis and would not be subject to a basis reduction under § 734(b) even if the partnership had a § 754 election in effect. In these circumstances, $50 of capital gain is potentially eliminated from the system, however.

The hot asset sale approach also raises certain complications where the distributee partner has insufficient basis in its partnership interest to absorb the partnership's adjusted basis in the distributed hot assets. This can lead to results inconsistent with the intent of § 751(b).

Example 3. Assume the same facts as Example 2, except that instead of distributing 2/3 of the cold asset to A, the partnership fully redeems A by a distribution of 2/3 of the hot asset ($100). Because only $50 of hot asset appreciation remains in the partnership after the distribution, B's and C's shares of that appreciation have been reduced by $25 each. Under the hot asset sale approach, PRS would be deemed to distribute the relinquished share of the hot asset ($50) equally to B and C and each would be treating as selling $25 worth of the hot asset to the partnership. B and C would each recognize $25 of ordinary income and would be treated as contributing $25 to the partnership. The portion of the hot asset deemed sold would take a cost basis, increasing the partnership's basis in the distributed portion of the distributed hot asset to $50. Because A's basis in its partnership interest is $0, however, the basis of the distributed hot asset would be reduced under § 732(b) to $0 in A's hands. If the partnership had a § 754 election in effect, the partnership would increase the basis of the retained hot asset under § 734(b) by $50. After the distribution, A's share of unrealized income in hot assets would still be $100, and B and C, who each recognized $25 of ordinary income, would recognize no additional ordinary income.

Commentators have suggested that, in these situations, it may be appropriate to permit or require the distributee partner to recognize capital gain to the extent the adjusted basis of the distributed hot assets exceeds that partner's basis in the partnership interest. In Example 3, A could elect, or be required, to recognize capital gain equal to the amount by which the adjusted basis of the distributed hot assets exceeds that partner's basis in the partnership interest ($50), thereby increasing A's basis to $50. The distributed hot asset would take a $50 basis in A's hands under § 732(b), and no § 734(b) adjustment would be made to the retained hot asset. If A recognizes capital gain on the distribution, future regulations could permit an equivalent increase to the basis of the partnership's retained cold assets.

Section 4. REQUEST FOR COMMENTS

The Treasury Department and the Service are conducting a study of the current § 751(b) regulations and are considering alternative approaches to achieving the purpose of the statute that would provide greater simplicity. For example, it may be possible to provide safe harbor methods for calculating the share of ordinary income or capital gain that should be recognized as a result of a disproportionate distribution that may reduce some administrative burden but still serve the purpose of the statute. In this regard, the Treasury Department and the Service request comments on the approaches discussed in this Notice (as well as other possible approaches) to determining a partner's share of hot assets and to prescribing the tax consequences of a disproportionate distribution. Comments are requested concerning the following issues:

A. For purposes of determining each partner's share of partnership assets before and after a distribution that may be subject to § 751(b),

(1) Whether the hypothetical sale approach (combined with the application of § 704(c) principles) for determining each partner's share of partnership assets provides an accurate and appropriate measure for purposes of § 751(b). In particular,

a. Whether special rules would be necessary to address situations in which the distributee partner's interest in unrealized appreciation in hot assets prior to the distribution exceeds the partner's interest in partnership capital after the distribution;

b. Whether the hypothetical sale approach should be modified to take into account changes in allocations that are planned or may occur in the future or changes in the partner's interest in anticipated future appreciation and depreciation in partnership assets;

c. The extent to which regulations adopting the hypothetical sale approach should take into account the distributee partner's basis in the partnership interest and basis adjustments under §§ 734(b) and 743(b), including basis adjustments resulting from the distribution;

d. Whether the partners' shares of partnership liabilities should be considered in determining the partners' shares of partnership assets, and how the rules of § 752 should be coordinated with those of § 751(b).

(2) Whether § 751(b) should be limited to transactions that change the partners' shares of unrealized appreciation in hot assets or should also apply to transactions that change the partners' shares of unrealized depreciation in hot assets.

(3) Whether other approaches to determining a partner's share of partnership hot and cold assets should be considered.

B. For purposes of simplifying the tax consequences of a distribution that is subject to § 751(b), whether the hot asset sale approach is an appropriate method of applying § 751(b) or whether other approaches should be considered. Comments are specifically requested on the following:

(1) Whether the regulations should provide a simple safe harbor that approximates the appropriate taxation of a disproportionate distribution and, if so, the appropriate parameters and availability of such a safe harbor.

(2) Whether the current § 751(b) regulations should be generally retained or retained in combination with a safe harbor, or whether the current § 751(b) regulations should be completely revised to adopt a new paradigm such as the hot asset sale approach.

(3) Whether mandatory or elective capital gain recognition should be included in the hot asset sale approach.

Comments should be submitted in writing on or before August 2, 2006 and should include a reference to Notice 2006-14. In addition to the topics on which comments are specifically requested above, comments are requested on any other matters that should be addressed in future guidance under § 751(b). Comments may be submitted to CC:PA:LPD:PR (Notice 2006-14), Room 5226, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, comments may be submitted electronically via the following e-mail address: Notice.Comments@irscounsel.treas.gov. Please include "Notice 2006-14" in the subject line of any electronic communications. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:PA:LPD:PR (Notice 2006-14), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224.

DRAFTING INFORMATION

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